

This sample document is derived from a sample document that was the work product of a coalition of attorneys who specialize in venture capital financings working under the auspices of the National Venture Capital Association (the “NVCA”) (the “NVCA sample document”). See the NVCA website at [nvca.org](http://nvca.org) for a list of the Working Group members. The NVCA sample document has been modified by the Corporations Committee of the Business Law Section of the State Bar of California for use by California corporations. The members of the Corporations Committee who had primary responsibility for modifying the NVCA sample documents for use by California corporations are Lemoine Skinner III, Bruce R. Deming, Matthew R. Gemello, Steven R. Harmon, Mark T. Hiraide, William Sawyers, David M. Serepca, James Thompson, and Bertha Willner. Robert Brigham of the NVCA Working Group reviewed these modifications. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample presents an array of (often mutually exclusive) options with respect to particular deal provisions. This sample document is based on the NVCA document whose date is set forth in the footer and does not reflect changes in that document.

## **TERM SHEET**

### ***Preliminary Notes***

*This Term Sheet maps to the NVCA model documents, as modified by the Corporations Committee of the Business Law Section of the State Bar of California. For convenience the provisions are grouped according to the particular model document in which they may be found. Although this Term Sheet is perhaps somewhat longer than a "typical" VC Term Sheet, the aim is to provide a level of detail that makes the Term Sheet useful as both a road map for the document drafters and as a reference source for the business people to quickly find deal terms without the necessity of having to consult the legal documents (assuming of course there have been no changes to the material deal terms prior to execution of the final documents).*

**TERM SHEET**  
**FOR SERIES A PREFERRED STOCK FINANCING OF**  
**[INSERT COMPANY NAME], INC.**  
**[\_\_\_\_\_, 200\_]**

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [\_\_\_\_\_] Inc., a California corporation (the “**Company**”). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality and Counsel and Expenses provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest nor an agreement to negotiate, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors.<sup>1</sup> This Term Sheet shall be governed in all respects by the laws of the State of California.

**Offering Terms**

*Closing Date:* As soon as practicable following the Company’s acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the “**Closing**”). *[provide for multiple closings if applicable]*

*Investors:* Investor No. 1: [\_\_\_\_\_] shares ([\_]%), \$[\_\_\_\_\_]   
Investor No. 2: [\_\_\_\_\_] shares ([\_]%), \$[\_\_\_\_\_]   
[as well other investors mutually agreed upon by Investors and the Company]

*Amount Raised:* \$[\_\_\_\_\_] [including \$[\_\_\_\_\_] from the conversion of principal [and interest] on bridge notes].<sup>2</sup>

*Price Per Share:* \$[\_\_\_\_\_] per share (based on the capitalization of the Company set forth below) (the “**Original Purchase Price**”).

*Pre-Money Valuation:* The Original Purchase Price is based upon a fully-diluted pre-money valuation of \$[\_\_\_\_\_] and a fully-diluted post-money valuation of \$[\_\_\_\_\_] (including an employee pool representing [%] of the fully-diluted post-money capitalization).

*Capitalization:* The Company’s capital structure before and after the Closing is set

---

<sup>1</sup> To minimize the risk of unintended enforcement of non-binding provisions of a term sheet or the finding of an agreement to negotiate, counsel should include an unequivocal statement that the parties do not intend to be bound until they execute and deliver formal documents. See Roth v. Garcia Marquez, 942 F.2d. 617 (9th Cir. 1991); Copeland v. Baskin Robbins U.S.A., 96 Cal. App.4th 1251 (2002).

<sup>2</sup> Modify this provision to account for staged investments or investments dependent on the achievement of milestones by the Company.

forth below:

Security	Pre-Financing		Post-Financing	
	# of Shares	%	# of Shares	%
Common – Founders				
Common – Employee Stock Pool				
Issued				
Unissued				
[Common – Warrants]				
Series A Preferred				
Total				

### **ARTICLES**<sup>3</sup>

#### *Dividends:*<sup>4</sup>

[*Alternative 1:* Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock]

[*Alternative 2:* Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to \$[\_\_\_\_\_] per share of Series A Preferred when and if declared by the Board.]

[*Alternative 3:* The Series A Preferred will carry an annual [\_\_]% cumulative dividend [compounded annually], payable upon a liquidation or redemption. For any other dividends or distributions, participation with Common Stock on an as-converted basis.]<sup>5</sup>

---

<sup>3</sup> The Articles of Incorporation are a public document, filed with the California Secretary of State, that establish all of the rights, preferences, privileges and restrictions of the Preferred Stock. California General Corporation Law Section 200 (hereafter, the “Corporations Code”). Note that the superior rights, preferences, and privileges granted to Preferred Stock are critical factors in discounting the fair market value of Common Stock or Common Stock options granted or issued to founders, executives and employees.

<sup>4</sup> Section 500 of the Corporations Code prohibits distributions to shareholders unless: (1) the amount of retained earnings of the corporation immediately before distribution equals or exceeds the amount of the proposed distribution, OR (2) if immediately after the distribution (a) the sum of the corporation’s assets (as adjusted) would be at least equal to 125% of its liabilities (as adjusted); AND (b) current assets would be at least equal to current liabilities (or in some circumstances at least equal to 125% of current liabilities).

<sup>5</sup> In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the Preferred Stock is converted. Another alternative is to

*Liquidation Preference:*<sup>6</sup>

In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

*[Alternative 1 (non-participating Preferred Stock):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. The balance of any proceeds shall be distributed to holders of Common Stock.]

*[Alternative 2 (full participating Preferred Stock):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis.]

*[Alternative 3 (cap on Preferred Stock participation rights):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of [\_\_\_\_] times the Original Purchase Price.]

A merger or consolidation (other than one in which shareholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a “**Deemed Liquidation Event**”), thereby triggering payment of the liquidation preferences described above [unless the holders of [\_\_\_\_]% of the Series A Preferred elect otherwise].<sup>7</sup>

*Voting Rights:*

The Series A Preferred Stock shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except

---

give the Company the option to pay accrued and unpaid dividends in cash or in Common Stock valued at fair market value. The latter are referred to as “PIK” (payment-in-kind) dividends.

<sup>6</sup> Corporations Code Section 502 prohibits a corporation from making a distribution to shareholders on any class of shares that are junior, with respect to the distribution of assets on liquidation, to outstanding shares of any other class of stock if, after giving effect to the distribution, the excess of the corporation’s assets over its liabilities would be less than the liquidation preference on all shares having a liquidation preference over the junior shares.

<sup>7</sup> As discussed in more detail in the commentary in the introduction to the model Articles of Incorporation, Section 710 of the Corporations Code limits super-majority voting provisions for most public and certain private California and quasi-California corporations in several ways, including a prohibition on any voting requirement in excess of 2/3rds of the outstanding shares or applicable class or series. The Corporations Committee of the Business Law Section of the State Bar of California expects to introduce a bill in the 2005/2006 session of the California legislature to amend Section 710 to eliminate the two-year sunset provision on supermajority voting provisions.

(i) the Series A Preferred as a class shall be entitled to elect [\_\_\_\_\_] [( )] members of the Board (the “**Series A Directors**”),<sup>8</sup>  
(ii) as provided under “Protective Provisions” below or (iii) as required by law. The Company’s Articles of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting separately and not as a single class.<sup>9</sup>

*Protective Provisions:*

So long as [insert fixed number, or %, or “any”] shares of Series A Preferred are outstanding, the Company will not, without the written consent of the holders of at least [ ]%<sup>10</sup> of the Company’s Series A Preferred, either directly or by amendment, merger, consolidation, or otherwise:

(i) liquidate, dissolve or wind-up the affairs of the Company, or effect any Deemed Liquidation Event; (ii) amend, alter, or repeal any provision of the Articles of Incorporation or Bylaws [in a manner adverse to the Series A Preferred];<sup>11</sup> (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, [other than stock repurchased from former employees or consultants in connection with the cessation of their employment/services, at the lower of fair market value or cost;] [other than as approved by the Board]<sup>12</sup>; or (v) create or authorize the creation of any debt

---

<sup>8</sup> Section 301(a) of the Corporations Code states that the Articles may provide for the election of one or more directors by the holders of the shares of any class or series voting as a class or series.

<sup>9</sup> Unlike Delaware law, Section 903(a)(1) of the Corporations Code does not permit a California corporation to “opt out” of the statutory requirement of a separate class vote by Common Shareholders to authorize shares of Common Stock.

<sup>10</sup> See footnote 7 regarding limitations on super-majority voting.

<sup>11</sup> Note that as a matter of background law, Section 903(a) of the California General Corporation Law provides that if any proposed charter amendment would increase or decrease the outstanding shares of a class or change the rights, preferences or privileges of any class, then the holders of that class are entitled to a separate vote on the amendment.

<sup>12</sup> The Certificate of Incorporation of a Delaware corporation may add “ including the Series A Directors” or “including at least one Series A Director.” See DGCL §141(d). Staff Counsel in the Business Programs Division of the Office of the California Secretary of State has taken the position that a provision requiring the consent of the Series A Directors or one Series A Director is not permitted by Corporations Code §204(a)(5) and conflicts with Corporations Code § 307(a)(8). As an alternative, under Corporations Code § 204(a)(5), approval of a super-majority of directors

security [if the Company's aggregate indebtedness would exceed \$[\_\_\_\_]][other than equipment leases or bank lines of credit][other than debt with no equity feature][unless such debt security has received the prior approval of the Board of Directors; (vi) increase or decrease the size of the Board of Directors.

*Optional Conversion:*

The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions."

*Anti-dilution Provisions:*

In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

[*Alternative 1: "Typical" weighted average:*

$$CP_2 = CP_1 * (A+B) / (A+C)$$

CP<sub>2</sub> = New Series A Conversion Price

CP<sub>1</sub> = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP<sub>1</sub>

C = Number of shares of stock issued in the subject transaction]

[*Alternative 2: Full-ratchet – the conversion price will be reduced to the price at which the new shares are issued.*]

[*Alternative 3: No price-based anti-dilution protection.*]

---

may be required by the Articles for most corporate actions or a provision requiring approval of these actions by one of more of the Series A directors may be included in a shareholders' agreement to which the corporation is a party. Cf. the protective provisions in Section 5.5 of the model Investors' Rights Agreement. Moreover, to ensure a particular class or series of shareholders are represented, approval of such class or series can be required under Corporations Code §204(a)(5). **[To be discussed with Betsy Bogart]**

The following issuances shall not trigger anti-dilution adjustment:<sup>13</sup>

(i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; and (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors; [(v) shares of Common Stock issued or issuable to banks, equipment lessors pursuant to a debt financing, equipment leasing or real property leasing transaction approved by the Board of Directors of the Corporation.]

*Mandatory Conversion:*

Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten public offering with a price of [\_\_\_] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations and similar events) and [net/gross] proceeds to the Company of not less than \$[\_\_\_\_\_] (a “QPO”),<sup>14</sup> or (ii) upon the written consent of the holders of [\_\_\_]% of the Series A Preferred.<sup>15</sup>

*[Pay-to-Play:*

[Unless the holders of [\_\_\_]%<sup>16</sup> of the Series A elect otherwise,] on any subsequent down round all [Major] Investors are required to participate to the full extent of their participation rights (as described below under “Investor Rights Agreement – Right to Participate Pro Rata in Future Rounds”), unless the participation requirement is waived for all [Major] Investors by the Board. All shares of Series A Preferred<sup>17</sup> of any [Major] Investor failing to do so will

---

<sup>13</sup> Note that additional exclusions are frequently negotiated, such as issuances in connection with equipment leasing and commercial borrowing.

<sup>14</sup> The per-share test ensures that the investor achieves a significant return on investment before the Company can go public. Also consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the investor, so that the investor does not have the power to block a public offering.

<sup>15</sup> See footnote 7 regarding limitations on super-majority voting.

<sup>16</sup> See footnote 7 regarding limitations on super-majority voting.

<sup>17</sup> Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of anti-dilution adjustment).

automatically [lose anti-dilution rights] [lose right to participate in future rounds] [convert to Common Stock and lose the right to a Board seat if applicable].<sup>18</sup>

*Redemption Rights:*<sup>19</sup>

The Series A Preferred shall be redeemable from funds legally available for distribution at the option of holders of at least [ ]%<sup>20</sup> of the Series A Preferred commencing any time after the fifth anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].<sup>21</sup>

## **STOCK PURCHASE AGREEMENT**

---

<sup>18</sup> If an investor's failure to participate in a subsequent financing round results in losing some but not all rights of their Preferred Stock (e.g., anything other than a forced conversion to Common Stock), the Articles of Incorporation will need to have so-called "blank check preferred" provisions at least to the extent necessary to enable the Board to issue a "shadow" class of Preferred Stock with diminished rights in the event an investor fails to participate. Note that as a drafting matter it is far easier to simply have (some or all of) the Preferred Stock convert to Common Stock. In order to effect the conversion of non-participating Preferred Stock into a new series of "Shadow" Preferred, it will be necessary to file a Certificate of Determination with the California Secretary of State. The Certificate of Determination may not effect any change in the terms of the Series A Preferred, but rather may only layer the new series on top of the existing series.

<sup>19</sup> Redemption rights allow Investors to force the Company to redeem their shares at cost [plus a small guaranteed rate of return (e.g., dividends)]. In practice, redemption rights are not often used; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a "deemed dividend" problem under Section 305 of the Internal Revenue Code, many tax practitioners take the view that if the liquidation preference provisions in the Articles of Incorporation are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the model Articles of Incorporation), then there is no Section 305 issue.

<sup>20</sup> See footnote 7 regarding limitations on super-majority voting.

<sup>21</sup> Due to statutory restrictions, it is unlikely that the Company will be legally permitted to redeem in the very circumstances where investors most want it (the so-called "sideways situation"), investors will sometimes request that certain penalty provisions take effect where redemption has been requested but the Company's available cash flow does not permit such redemption - - e.g., the redemption amount shall be paid in the form of a one-year note to each unredeemed holder of Series A Preferred, and the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors until such amounts are paid in full. As discussed in more detail in the commentary in the introduction to the model Articles of Incorporation, Section 500 of the California Corporations Code restricts the ability of California and quasi-California corporations to make distributions of cash or property to shareholders.

*Representations and Warranties:* Standard representations and warranties by the Company. [Representations and warranties by Founders regarding [technology ownership, etc.].<sup>22</sup>

*Conditions to Closing:* Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of the Articles of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company.

*Counsel and Expenses:* [Investor/Company] counsel to draft closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed \$[\_\_\_\_]) and expenses of Investor counsel[, unless the transaction is not completed because the Investors withdraw their commitment without cause]<sup>23</sup>.

Company Counsel: [\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_]

Investor Counsel: [\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_]

## **INVESTOR RIGHTS AGREEMENT**

### *Registration Rights:*

*Registrable Securities:* All shares of Common Stock issuable upon conversion of the Series A Preferred and [any other Common Stock held by the Investors] will be deemed “**Registrable Securities**.”<sup>24</sup>

*Demand Registration:* Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months following an initial public offering (“**IPO**”), persons holding [\_\_]% of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than

---

<sup>22</sup> Note that while it is not at all uncommon in East Coast deals to require the Founders to personally represent and warrant at least as to certain key matters (usually only in the Series A round), such Founders representations are rarely found in West Coast financing transactions.

<sup>23</sup> The bracketed text should be deleted if this section is not designated in the introductory paragraph as one of the sections that is binding upon the Company regardless of whether the financing is consummated.

<sup>24</sup> Note that Founders/management sometimes also seek registration rights.

\$[5-10] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).

*Registration on Form S-3:* The holders of [10-30]% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least \$[1-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two] per year.

*Piggyback Registration:* The holders of Registrable Securities will be entitled to “piggyback” registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [30]% on a pro rata basis and to complete reduction on an IPO at the underwriter’s discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other shareholders’ shares are reduced.

*Expenses:* The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions) will be borne by the Company. The Company will also pay the reasonable fees and expenses[, not to exceed \$\_\_\_\_\_,] of one special counsel to represent all the participating shareholders.

*Lock-up:* Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(excluding shares acquired in or following the IPO)] for a period of up to 180 days following the IPO (provided all directors and officers of the Company and [1 – 5]% shareholders agree to the same lock-up). Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to [Major] Investors, pro rata, based on the number of shares held. A “**Major Investor**” means any Investor who purchases at least \$[\_\_\_\_\_] of Series A Preferred.

*Termination:* Earlier of [5] years after IPO, upon a Deemed Liquidation Event, or when all shares of an Investor are eligible to be sold without restriction under Rule 144(k) within any 90-day period.

No future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor’s rights.

*Management and Information Rights:*

A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.<sup>25</sup>

Any Major Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year; and (iii) promptly following the end of each quarter an up-to-date capitalization table, certified by the CFO.

*Right to Participate Pro Rata in Future Rounds:*

All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet and issuances in connection with acquisitions by the Company). In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

*Matters Requiring Investor Director Approval:*

[So long as [\_\_]% of the originally issued Series A Preferred remains outstanding] the Company will not, without Board approval:

- (i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including, any employee or director, except advances and similar expenditures in the ordinary course of business or under the terms of a employee stock or option plan approved by the Board of Directors; (iii) guarantee, any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; (iv) make any investment other than investments in prime commercial paper, money market funds, certificates of deposit in any United States bank having a net worth in excess of \$100,000,000 or obligations issued or guaranteed by the United

---

<sup>25</sup> See commentary in introduction to the model Managements Rights Letter, explaining purpose of such letter.

States of America, in each case having a maturity not in excess of [two years]; (v) incur any aggregate indebtedness in excess of \$[\_\_\_\_\_] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any “associate” (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than \$[60,000] per year], [or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company’s business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];<sup>26</sup> (vii) hire, fire, or change the compensation of the executive officers, including approving any option plans; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; or (ix) sell, transfer, license, pledge or encumber technology or intellectual property, other than licenses granted in the ordinary course of business.

*Non-Solicitation Agreements:*<sup>27</sup>

Each Founder and key employee will enter into a [one] year non-solicitation agreement in a form reasonably acceptable to the Investors.

*Non-Disclosure and  
Developments Agreement:*

Each current and former Founder, employee and consultant with access to Company confidential information/trade secrets will enter into a non-disclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.

*Board Matters:*

Each Board Committee shall include at least one Series A Director.

The Board of Directors shall meet at least [monthly][quarterly], unless otherwise agreed by a vote of the majority of Directors.

The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. In the event the

---

<sup>26</sup> With limited exceptions, Section 402 of the Sarbanes-Oxley Act requires repayment of any loans to directors and executives in full prior to the Company filing a registration statement for an IPO.

<sup>27</sup> Although reasonable prohibitions against solicitation of employees are generally enforceable under California law, non-compete restrictions (other than in connection with the sale of a business or the sale of equity interests in an entity engaged in business) are prohibited in California. California Bus. & Prof. Code Section 16600-16607. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Non-Solicit (and indeed the agreement may arguably be invalid absent such additional consideration - although having an employee sign a non-solicit contemporaneous with hiring constitutes adequate consideration). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement.

Company merges with another entity and is not the surviving corporation, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume Company's obligations with respect to indemnification of Directors.

*Employee Stock Options:*

All employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].<sup>28</sup>

[Immediately prior to the Series A Preferred Stock investment, [\_\_\_\_\_] shares will be added to the option pool creating an unallocated option pool of [\_\_\_\_\_] shares.]

*Key Person Insurance:*

Company to acquire life insurance on Founders [*name each Founder*] in an amount satisfactory to the Board. Proceeds payable to the Company.

*[IPO Directed Shares]:*<sup>29</sup>

To the extent permitted by applicable law and SEC policy, upon an IPO consummated one year after Closing, Company to use reasonable best efforts to cause underwriters to designate [10]% of the offering as directed shares, 50% of which shall be allocated by Major Investors.]

*[QSB Stock:*

Company shall use reasonable best efforts to cause its capital stock to constitute Qualified Small Business Stock unless the Board determines that such qualification is inconsistent with the best interests of the Company.]

*Termination:*

All rights under the Investor Rights Agreement, other than registration rights, shall terminate upon the earlier of an IPO, a Deemed Liquidation Event or a transfer of more than 50% of Company's voting power.

**RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT  
AND VOTING AGREEMENT**

*Right of first Refusal/*

Company first and Investors second (to the extent assigned by the

---

<sup>28</sup> Sections 260.140.41 and 260.140.42 of the California Code of Regulations impose a number of restrictions on the terms of employee stock options and restricted stock awards issued in reliance on the stock plan securities exemption set forth in Section 25102(o) of the Corporations Code, including among others, a requirement that employees vest at the rate of at least 20% per year over 5 years from the date of grant. These restrictions are inapplicable to listed corporations who need not rely on the exemption found in 25102(o).

<sup>29</sup> SEC Staff examiners have taken position that, if contractual right to friends and family shares was granted less than 12 months prior to filing of registration statement, this will be considered an "offer" made prematurely before filing of IPO prospectus. So, investors need to agree to drop shares from offering if that would hold up the IPO. While some documents provide for alternative parallel private placement where the IPO does occur within 12 months, such a parallel private placement could raise integration issues and negatively impact the IPO. Hence, such an alternative is not provided for here.

*Right of Co-Sale (Take-me-Along):*

Board of Directors,) have a right of first refusal with respect to any shares of capital stock of the Company proposed to be sold by Founders [and employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock)], with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.<sup>30</sup>

*Board of Directors:*

At the initial Closing, the Board shall consist of [\_\_\_\_\_] members comprised of (i) [Name] as [the representative designated by [\_\_\_\_]], as the lead Investor, (ii) [Name] as the representative designated by the remaining Investors, (iii) [Name] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [\_\_\_\_] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].

*[Drag Along:*

Holders of Preferred Stock and the Founders [and all current and future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such shareholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred, approved by [the Board of Directors] [and the holders of a [majority][super majority] of the outstanding shares of Preferred Stock, on an as-converted basis].

*Termination:*

All rights under the Right of First Refusal/Co-Sale and Voting Agreements shall terminate upon an IPO, a Deemed Liquidation Event or a transfer of more than 50% of Company's voting power.

### **OTHER MATTERS**

*Founders' Stock:*

All Founders to own stock outright subject to Company right to buyback at cost. Buyback right for [\_\_\_\_]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [\_\_\_\_] months.

*[Existing Preferred Stock<sup>31</sup>:*

The terms set forth below for the Series [\_\_\_\_] Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing

---

<sup>30</sup> Certain exceptions are typically negotiated, e.g., estate planning or *de minimis* transfers

<sup>31</sup> Necessary only if this is a later round of financing, and not the initial Series A round.

Preferred Stock to this term sheet will be made at the Closing.]

*No Shop/Confidentiality:*

The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of [six] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [\_\_\_\_], closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to the Investors \$[\_\_\_\_] upon the closing of any such transaction as liquidated damages.]<sup>32</sup> The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [\_\_\_\_], as lead Investor, without the written consent of the Investors.

*Expiration:*

This Term Sheet expires on [\_\_\_\_ \_\_, 200\_] if not accepted by the Company by that date.

EXECUTED THIS [\_\_] DAY OF [\_\_\_\_], 200[\_\_].<sup>33</sup>

[SIGNATURE BLOCKS]

---

<sup>32</sup> It is unusual to provide for such "break-up" fees in connection with a venture capital financing, but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later stage deal).

<sup>33</sup> Some practitioners elect not to sign term sheets. If that course is taken, a practitioner should ensure that any binding provisions, such as confidentiality or exclusivity, are set forth in a separate document signed by the party or parties to be bound.